

HEALTH INSURANCE FOR THE AGED

PROVIDER REIMBURSEMENT MANUAL

MANUALS

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FOREWORD

This manual is for use by providers of services in computing the reasonable cost of services furnished under the provisions of the Health Insurance for the Aged Act of 1965, as amended. The procedures and methods in this manual have been devised to accommodate program needs and the administrative needs of providers and their intermediaries. The manual contains informational and procedural material on various aspects of the determination of cost and will assist providers in preparing annual cost reports. This manual will assure that the reasonable cost regulations are uniformly applied nationally without regard to where covered services are furnished. The provider's intermediary will issue any necessary supplementary instructions as appropriate for local guidance on items relating to cost determination.

The provisions of the law and the regulations are accurately reflected in this manual, but it does not have the effect of regulations.

The manual will accommodate new pages or revisions as further interpretations of the regulations and changes in procedures and methods are made. Accordingly, revised sections, pages, or chapters will be issued as necessary.

Questions by a provider on cost policies and procedures in the program should be referred to the provider's intermediary. Providers dealing directly with the Social Security Administration may refer questions on cost determinations to the Bureau of Health Insurance Regional Representative.

THOMAS M. TIERNEY
Director, Bureau of Health Insurance

NOTE: Chapter I, Depreciation, is the first of several chapters which will constitute the manual. Other chapters will be released as they become available.

INTRODUCTION

Regulations pertaining to the medicare program set forth principles to be followed in determining the reasonable cost of provider services. These "Principles of Reimbursement for Provider Costs" have also been published in HIM-5. This manual provides guidelines and policies to be followed in implementing the cost principles. For any cost situation that is not covered by the manual's guidelines and policies, generally accepted accounting principles should be applied.

Under generally accepted accounting principles, or under the "Principles of Reimbursement for Provider Costs" there may be more than one method for handling a particular cost item; in such case the method elected by the provider must be consistently followed in subsequent reporting periods. A change of method must be approved by the intermediary (or SSA for providers dealing direct) on a prospective and not retrospective basis. Where the manual sets a time limit for requesting such change, or limits the number of changes, the provider and intermediary will be guided by the manual instructions.

If a provider has any question on how to determine reasonable cost, or how to apply any part of this manual in a particular situation, it should submit the question to its intermediary (or to the Social Security Administration if it deals with the Government). Answers to questions raised by some providers which may be of interest to other providers will periodically be added to the applicable chapters and sections of this manual.

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Chapter I

DEPRECIATION

100. GENERAL

The principles of reimbursement for provider costs provide that payment for services should include depreciation on all depreciable type assets that are used to provide covered services to beneficiaries. This includes assets that may have been fully (or partially) depreciated on the books of the provider but are in use at the time the provider enters the program. The useful lives of such assets are considered not to have ended and depreciation calculated on a revised extended useful life is allowable. Likewise, a depreciation allowance is permitted on assets that are used in a normal standby or emergency capacity.

Three methods of prorating the cost of depreciable assets are available: straight-line, declining balance, and sum-of-the-years' digits. The method chosen for the medicare program for an asset or groups of assets need not correspond to the methods used by the provider for nonmedicare purposes.

102. PRINCIPLES

An appropriate allowance for depreciation on buildings and equipment is an allowable cost. The depreciation must be: (a) identifiable and recorded in the provider's accounting records; (b) based on the historical cost of the asset or fair market value at the time of donation in the case of donated assets; and (c) prorated over the estimated useful life of the asset using the straight-line method or accelerated depreciation under the declining balance or sum-of-the-years' digits methods.

Depreciation on assets being used by a provider at the time it enters into the Title XVIII program is allowed; this applies even though such assets may be fully or partially depreciated on the provider's books.

With respect to all assets acquired before 1966, the provider, at its option, may choose an allowance for depreciation based on a percentage of operating costs. The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percent to be applied is 5 percent starting with the year 1966-67, with such

percentage being uniformly reduced by one-half percent each succeeding year. The allowance based on operating costs is in addition to a regular depreciation on assets acquired after 1965; however, when the optional allowance is selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired or rented after 1965 may not exceed 6 percent of the provider's allowable cost for the current year.

Depreciation is allowed on assets financed with Hill-Burton or other Federal or public funds.

104. DEFINITIONS

Depreciation is that amount which represents a portion of the depreciable asset's cost or other basis which is allocable to a period of operation. The amount of depreciation is determined by the provider's method of depreciation accounting.

The American Institute of Certified Public Accountants defines depreciation as a process of cost allocation:

"Depreciation accounting is a system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year."

104.1 Depreciable Assets.—Assets that a provider has an economic interest in through ownership—regardless of the manner in which they were acquired—are subject to depreciation. Generally, depreciation is allowable on the assets described below when required in the regular course of providing patient care. Assets which a provider is using under a regular lease arrangement would not be subject to depreciation by the provider. (See section on Lease-Purchase and Sale-Lease-Back Agreements (§ 110).)

In general, assets subject to depreciation are de-

scribed in the AHA Chart of Accounts for Hospitals, M-58, 15M-8 66-183305, and for the most part are also subject to depreciation for medicare purposes. However, see the treatment of minor equipment as described below.

104.2 Buildings.—Building includes, in a restrictive sense, the basic structure or shell and additions thereto. The remainder is identified as building equipment.

104.3 Building Equipment.—Building equipment includes attachments to buildings, such as wiring, electrical fixtures, plumbing, elevators, heating system, air conditioning system, etc. The general characteristics of this equipment are: (a) affixed to the building, and not subject to transfer; and (b) a fairly long life, but shorter than the life of the building to which affixed. Since the useful lives of such equipment are shorter than those of the buildings, the equipment may be separated from building cost and depreciated over this shorter useful life.

104.4 Major Moveable Equipment. Major moveable equipment includes such items as accounting machines, beds, wheelchairs, desks, vehicles, X-ray machines, etc. The general characteristics of this equipment are: (a) a relatively fixed location in the building; (b) capable of being moved as distinguished from building equipment; (c) a unit cost sufficient to justify ledger control; (d) sufficient size and identity to make control feasible by means of identification tags; and (e) a minimum life of approximately three years.

104.5 Minor Equipment.—Minor equipment includes such items as waste baskets, bed pans, syringes, catheters, silverware, mops, buckets, etc. The general characteristics of this equipment are: (a) in general, no fixed location and subject to use by various departments of the provider's facility; (b) comparatively small in size and unit cost; (c) subject to inventory control; (d) fairly large quantity in use; and, (e) generally, a useful life of approximately three years or less.

104.6 Land (Non-depreciable).—Land (non-depreciable) includes the land owned and used in provider operations. Included in the cost of land are the costs of such items as off-site sewer and water lines, public utility charges necessary to service the land, governmental assessments for street paving and sewers, the cost of permanent roadways and grading

of a non-depreciable nature, the cost of curbs and sidewalks whose replacements is not the responsibility of the provider and other land expenditures of a non-depreciable nature.

104.7 Land Improvements (Depreciable).—Depreciable land improvements include paving, tunnels, underpasses, on-site sewer and water lines, parking lots, shrubbery, fences, walls, etc. (if replacement is the responsibility of the provider).

104.8 Leasehold Improvements. — Leasehold improvements include betterments and additions made by the lessee to the leased property. Such improvements become the property of the lessor after the expiration of the lease.

104.9 Accounting Records.—The depreciation allowance, to be acceptable, must be adequately supported by the provider's accounting records. For medicare purposes, a provider may maintain supplementary records apart from formal records, but in a manner similar to that used in maintaining formal records. Appropriate recording of depreciation requires the identification of the depreciable assets in use, the assets' historical costs (or fair market value at the time of donation in the case of donated assets), the method of depreciation, and the assets' accumulated depreciation.

104.10 Historical Cost.—Historical cost is the cost incurred by the present owner in acquiring the asset and to prepare it for use. Such cost includes costs that would be capitalized under generally accepted accounting principles. For example, in addition to the purchase price, historical cost would include architectural fees, consulting fees, related legal fees.

104.11 Historical Cost, Trade-Ins.—When an asset is acquired by trading in an asset that was depreciated under the program, the cost of the new asset would be the sum of the undepreciated balance of the old asset and the cash paid or to be paid. Where the old asset was acquired by the provider before entrance into the program, and the sum of the undepreciated balance and the cost paid or to be paid exceeds the list price, the cost of the new asset will be the list price.

For assets having no historical or appraisal values assigned, the cost basis shall be the fair market value at the date of disposal of the old asset plus the sum paid but not to exceed the list price.

104.12 Appraisals.—Where historical cost records of a purchased asset are not available an appraisal of the historical cost of the asset made by a recognized expert will be acceptable for depreciation and owner's equity capital purposes. Before an appraisal is made, the provider should inform its intermediary (or the Social Security Administration if the provider is dealing directly with the Government) of the appraisal expert, and the type and method of appraisal he will use. The intermediary (or SSA) will determine whether the contemplated appraisal for determining historical cost will be acceptable.

The appraisal of the historical cost of assets should produce a value approximating the cost of reproducing substantially identical assets of like type, quality, and quantity at a price level in a bona fide market as of the date of acquisition. The appraisal expert making the appraisal should be one who is recognized as an appraisal authority based on sufficient experience and background in determining the historical cost of used assets.

104.13 Lease-Purchase Assets.—The historical cost of such assets is the sum of the lease payments and any additional payments made to acquire the assets, excluding the amount allowed as rent during the period of the lease or rental arrangement.

104.14 Purchase of Facility As An On-Going Operation.—In establishing the historical cost of assets where an on-going facility is purchased through a bona fide sale after June 30, 1966, the sale price or portion thereof attributable to the asset must not exceed the fair market value of the asset at the time of sale. If the facility was being operated under the program at the time of sale, the sale price used by the seller in computing gain or loss for the final cost report, must agree with the historical cost used by the new provider in computing depreciation.

If a purchaser cannot demonstrate that the sale was bona fide, the lesser of the seller's net book value or sale price shall be used by the purchaser as the historical cost of the asset. In such cases, the difference between the sale price and the net book value shall be considered good will. The good will so established is not amortizable.

104.15 Fair Market Value—Donated Assets.—Fair market value is the price that the asset would bring by bona fide bargaining between well-informed buyers and sellers at the date of acquisition. Usually the fair market price will be the price at which bona fide sales have been consummated for assets of like

type, quality and quantity in a particular market at the time of acquisition. An asset is considered *donated* when the provider acquires the asset without making any payment for it in the form of cash, property, or services. When the provider makes any such payment in acquiring the asset, then this payment, and not the fair market value, is considered to be the historical cost of the asset.

104.16 Donated Assets — Appraisals.—Where the provider's records do not contain the fair market value of the donated assets as of the date of donation, an appraisal of such fair market value by a recognized appraisal expert will be acceptable for depreciation and owner's equity capital purposes.

The provider should furnish its intermediary (or the Social Security Administration if the provider deals directly with the Government) with information identifying the appraisal expert, and type and method of appraisal to be used. The intermediary (or SSA) will determine whether the contemplated appraisal will be acceptable.

104.17 Useful Life of Depreciable Assets.—The depreciable life of an asset is its expected useful life to the provider; not necessarily the inherent useful or physical life. The useful life is determined in the light of the provider's experience and the general nature of the asset and other pertinent data. Some factors for consideration are: (a) normal wear and tear, (b) obsolescence due to normal economic and technological advances, (c) climatic and other local conditions, (d) provider's policy for repairs and replacement, and (e) expected or known retirement date.

Providers may utilize the useful life guidelines published by the American Hospital Association or the Internal Revenue Service. A different life may be used; however, when the life selected differs significantly from that established by the guides, it must be supported by adequate documentation. Also, a composite useful life may be used for a class or group of assets.

104.18 Useful Life, Leasehold Improvements.—The cost of improvements which are the responsibility of the provider under the terms of a lease may be depreciated over the useful life of the improvement or the remaining term of the lease, whichever is shorter. The term of the lease includes any period for which the lease may be renewed, extended, or continued following either an option exercised by the

provider or in the absence of an option, reasonable interpretation of past acts of the lessor and lessee pertaining to renewal, etc.: unless the provider establishes omitting past acts, that it will probably not renew, extend, or continue the lease.

104.19 Salvage Value, Depreciable Assets.—

Salvage value is the estimated amount expected to be realized upon the sale or other disposition of the depreciable asset when it is no longer useful to the provider. The amount is ordinarily estimated at the time of acquisition and except for the declining balance method, is deducted from the cost of the depreciable property to arrive at the basis for depreciation. For example, an asset is purchased for \$17,000 with an expected salvage value of \$2,000; the basis for depreciation becomes \$15,000—i.e., \$17,000 less \$2,000—for computing the depreciation.

Thus, if a provider disposes of its assets when they are in good operating condition, the salvage value would be higher than it might if the provider used the assets until their inherent life had been substantially exhausted.

106. METHODS FOR WRITING OFF COST OF MINOR EQUIPMENT

The original cost of the minor equipment needed to operate the provider's facility may be treated in any of the following methods:

- a. The original investment in this equipment is not amortized or depreciated. Any replacements are charged to operating expense. The investment in non-amortizable equipment is adjusted periodically by increases; or
- b. The inventory cost of such items at the time the provider enters the program may be written off ratably over 3 years; that is, 1/3 of the inventory cost is written off each year. Any new purchases will also be written off ratably over a 3-year period; or
- c. Certain categories of equipment such as, for example, surgical instruments, may be written off ratably over their actual useful lives.

108. CAPITALIZATION OF EXPENDITURES FOR DEPRECIABLE ASSETS

Realistic standards must be set by providers in establishing the cost and useful lives of depreciable assets purchased which will be capitalized. For example, the policy of a particular provider may be to capitalize all depreciable asset expenditures of \$50.00 or more when the asset has an estimated useful life of

three years or longer, while asset expenditures of less than \$50 would be charged to expense. The standards so established must be followed consistently. Irrespective of the policy established, depreciable assets costing \$100 or more must be capitalized. Where an asset is purchased in quantity so that the cost of the quantity exceeds \$200 the cost of the individual items must be capitalized.

110. SALE AND LEASEBACK AND LEASE-PURCHASE AGREEMENTS

A. Sale and Leaseback Agreements—Rental Charges.—Rental costs specified in sale and leaseback agreements, incurred by providers through selling plant facilities or equipment to a purchaser not connected with or related to the provider and concurrently leasing back the same facilities or equipment are includable in allowable costs if these conditions are met:

1. The rental charges are reasonable based on consideration of rental charges of comparable facilities and market conditions in the area; the type, expected life, condition and value of the facilities or equipment rented and other provisions of the rental agreements;
2. Adequate alternate facilities or equipment which would serve the purpose are not or were not available at lower cost;
3. The leasing was based on economic and technical considerations. If all these conditions are not met, the rental charge cannot exceed the amount which the provider would have included in reimbursable costs had he retained legal title to the facilities or equipment, such as interest on mortgage, taxes, depreciation, insurance and maintenance costs.

B. Lease Purchase Agreements—Rental Charges.—Some lease agreements are essentially the same as installment purchases of facilities or equipment. If the lease is a virtual purchase, the rental charge is includable in allowable costs only to the extent that it does not exceed the amount which the provider would have included in allowable costs had he had legal title to the asset, such as, for example, straight-line depreciation, insurance, and interest. The difference between the amount of rent paid and the amount of rent allowed as rental expense is considered a deferred charge and is capitalized as part of the historical cost of the asset when the asset is purchased. If the asset is returned to the owner, instead of being purchased, the deferred charge may be expensed in the year

the asset is returned. If the asset continues to be rented after the due date for the purchase, and rental has been reduced, the deferred charge may be expensed to the extent of increasing the reduced rental to a fair market rental value.

The existence of the following conditions will generally establish that a lease is a virtual purchase:

1. The rental charge exceeds rental charges of comparable facilities or equipment in the area;
2. The term of the lease is less than the useful life of the facilities or equipment; and
3. The provider has the option to renew the lease at a significantly reduced rental, or the provider has the right to purchase the facilities or equipment at a price which appears to be significantly less than what the fair market value of the facilities or equipment would be at the time or times acquisition by the provider is permitted.

112. ALLOWANCE FOR DEPRECIATION ON FACILITIES LEASED FOR A NOMINAL AMOUNT

A considerable number of providers lease their facilities from municipalities at a nominal rental—usually for \$1.00 per year—the lease generally covering the useful life of the facility. Under most lease arrangements the tenant (lessee) maintains the property and pays the cost of any improvement or addition to the facility. When such improvement or addition is made the lessee may properly amortize its cost. The amortization allowance is includable in allowable cost. At the end of the lease, improvements and additions made by the lessee become the property of the lessor. However, in some instances the lease agreement provides that title to any additions or improvements is to revert to the owner in the first year they are used. In such case the cost of any addition or improvement would be similarly amortized and the amortization allowance would likewise be includable in allowable cost.

It is the general practice of the provider to include in its charges (and cost) an amount to cover depreciation on the leased facilities as distinguished from capital improvements made by the lessee. In recognition of this practice, most third parties that reimburse providers on the basis of cost allow depreciation on facilities that have been leased for a nominal rental. In view of the above and since the lease arrangement in such cases generally contemplates the occupancy by the lessee for the period of the useful life of the fa-

cility, depreciation on the leased facility may be included in allowable cost under the conditions described below.

112.1 Analysis of Lease Arrangement.—Each case must be decided on its own merits for depreciation to be allowed. The lease must contemplate that the lessee will make any necessary improvements and will properly maintain the facility. The lease may and frequently does cover the useful life of the asset; however, if the lease does not do so, such as a year to year lease, such lease should be examined closely to determine whether the renewal and other provisions of the lease contemplate that the provider will use the facility to the extent of their useful lives. Where the intent and provisions of the year to year lease permit the provider to have the benefit of the useful life of the facility, such lease should be treated, for depreciation purposes, in the same manner as a long-term lease that covers the useful life of the asset. The actions of the lessee and lessor in such cases should indicate that the intent of both parties is to continue the lease arrangements for the useful life of the asset. Of course, other facts should be considered together with the past actions of the lessee and lessor in order to determine whether or not the asset will and can be used by the lessee for the asset's full useful life.

The lease should have no restrictions on the free use of the facility by the lessee. In addition, the lease should not provide for any indirect benefits to the lessor or to those connected with the lessor. For example, if the lease requires that the lessee furnish free hospital services to the employees of the lessor, then depreciation in such case should not be allowed. In such case, the cost of the services furnished to the lessor's employees would be appropriately included when determining medicare's share of allowable costs.

Where the provider pays or contributes to the lessor any funds which are to be used for retiring the lessor's bonds or notes issued for the facility, such payments will be considered rental payments. These rental payments, to the extent they are reasonable, will be considered an allowable cost; likewise, any general contribution by the lessee to the lessor will be considered a rental payment for the use of the facility. Where either of such rental payments is allowable as cost, depreciation on the leased facility will not be an allowable cost item.

Any questions on the legal interpretation of the lease as it relates to the criteria discussed above, should be submitted through the Bureau of Health

Insurance regional office for an opinion from the regional attorney.

112.2 Basis and Method for Depreciation.—

The leased asset should be treated for depreciation cost allowance purposes under the program as though the lessor and lessee were one and the same. All the cost principles and reimbursement manual sections on depreciation would be applicable to such assets. For example, the basis for depreciation will be the historical cost of the asset to the lessor adjusted for past depreciation; and if historical cost records are not available, a proper appraisal for establishing the historical cost would be acceptable. Where the leased facility is later purchased by the provider, the facility's undepreciated balance on the date of title transfer or the purchase price, whichever is lower, will for further depreciation purposes be considered the unrecovered cost of the facility.

The following illustration demonstrates how depreciation would be computed on the leased facility and amortization on improvements made to that facility.

Facts

Historical cost of the leased facility at acquisition date—7/1/56	\$520,000
Estimated salvage value	\$ 20,000
Estimated useful life of the facility	40 years
Life of the lease effective at 7/1/60	35 years
Method for depreciation	Straight line
Leasehold improvement 7/1/65	\$ 90,000
Estimated useful life of improvement	30 years

Computation of Depreciation

Historical cost of building ..	\$520,000
Less: Estimated salvage value ..	20,000
Basis for depreciation	\$500,000
Annual rate of depreciation based on 40 year life	2.5%
Annual depreciation on building	\$ 12,500
Accumulated depreciation on 7/1/66* (10 years @ \$12,500)	\$125,000

Computation of Amortization on Improvement

Cost of leasehold improvement	\$ 90,000
Useful life—30 years	
Annual amortization	\$ 90,000 ÷ 30 years = \$ 3,000
Accumulated amortization on 7/1/66 *	\$ 3,000

Total Annual Depreciation and Amortization

Annual depreciation on facility	\$ 12,500
Annual amortization on improvement	3,000
Total	\$ 15,500

* Date of entrance into medicare program.

114. BASIS FOR DEPRECIATION

A. *New Assets.*—The basis for depreciation of new

assets under the straight-line and sum-of-the-years' digits methods is the historical cost of the asset (or fair market value in the case of donated assets) less its salvage value. Under the declining balance method, the basis for depreciation is the historical cost only.

B. *Used Assets—Partially or Fully Depreciated on the Providers' Books.*—The adjusted historical cost of the asset as determined below is to be used for determining the basis for depreciation under the three approved methods for depreciation. For the straight-line and sum-of-the-years' digits methods, the basis for depreciation would be the adjusted historical cost reduced by the estimated salvage value. Where the declining balance method is used, the basis for depreciation would be the adjusted cost of the asset.

The adjusted historical cost of an asset that is in use when the provider enters the program is its historical cost reduced by the depreciation accumulated up to the date of entrance into the program. Accumulated depreciation for this purpose may be determined on a straight-line basis (regardless of the depreciation method used or in use by the provider) and based on an estimate of the asset's useful life taking into account past and current information. Thus, if an asset currently in use has been fully depreciated on the provider's books it would be evident that an asset's useful life has not ended. Consequently, a new estimate of the asset's useful life, based on current information, may be made.

The following examples illustrate how the basis for depreciation is determined for used assets:

Facts

Historical cost of the asset	\$25,600
Estimated salvage value	\$ 1,600
Asset acquired on July 1, 1962.	
Original estimated useful life is eight years.	
On July 1, 1966, the asset's useful life is estimated to be twelve years from date of acquisition.	

1. Provider had previously used straight-line method for depreciation—Assets partially depreciated

Accumulated depreciation on the books	\$12,000
Accumulated depreciation for medicare purposes:	
Historical cost	\$25,600
Estimated salvage value	1,600
Basis for computing accumulated depreciation	\$24,000
Adjusted accumulated depreciation (4/12 x \$24,000)	8,000
Adjusted historical cost:	
Historical cost	\$25,600
Less: Adjusted accumulated depreciation	8,000
Adjusted historical cost	\$17,600
Basis for depreciation under the program:	
Declining balance method of depreciation: (Adjusted historical cost)	\$17,600

Straight-line and sum-of-the-years' digits methods:	
Adjusted historical cost	\$17,600
Less: Estimated salvage value	1,600
Basis for depreciation	<u>\$16,000</u>

2. Provider had previously used sum-of-the-years' digits for depreciation—Assets partially depreciated

Accumulated depreciation on the books	\$17,333
Accumulated depreciation for medicare purposes:	
Historical cost	\$25,600
Estimated salvage value	1,600
Basis for computing accumulated depreciation	<u>\$24,000</u>
Adjusted accumulated depreciation, using the straight-line method for depreciation	
(4/12 x \$24,000)	<u>\$ 8,000</u>
Adjusted historical cost:	
Historical cost	\$25,600
Less: Adjusted accumulated depreciation	8,000
Adjusted historical cost	<u>\$17,600</u>
Basis for depreciation under the program:	
Declining balance method	
(Adjusted historical cost)	<u>\$17,600</u>
Straight-line and sum-of-the-years' digits methods:	
Adjusted historical cost	\$17,600
Less: Estimated salvage value	1,600
Basis for depreciation	<u>\$16,000</u>

3. Provider had previously used declining balance method—Asset partially depreciated

Accumulated depreciation on the provider's books	\$17,500
Accumulated depreciation for medicare purposes:	
Historical cost	\$25,600
Estimated salvage value	1,600
Basis for computing accumulated depreciation	<u>\$24,000</u>
Adjusted accumulated depreciation, using the straight-line method for depreciation	
(4/12 x \$24,000)	<u>\$ 8,000</u>
Adjusted historical cost:	
Historical cost	\$25,600
Less: Adjusted accumulated depreciation	8,000
Adjusted historical cost	<u>\$17,600</u>
Basis for depreciation under the program:	
Declining balance method	
(Adjusted historical cost)	<u>\$17,600</u>
Straight-line and sum-of-the-years' digits methods:	
Adjusted historical cost	\$17,600
Less: Estimated salvage value	1,600
Basis for depreciation	<u>\$16,000</u>

116. DEPRECIATION METHODS

Three methods are acceptable for computing depreciation, namely the straight-line, sum-of-the-years' digits, and declining balance methods. However, the accelerated methods of depreciation—sum-of-the-years' digits and declining balance may be used only if the assets' expected useful life under the program is more than three years. Regardless of the method of depreciation being used, an asset should not be depreciated below its salvage value. (See § 104.19 on Salvage

Value.) No additional first year bonus depreciation is allowable. A provider may elect any one of the three acceptable methods. A formal election procedure is unnecessary for depreciable assets held at the time of entrance in the program or for assets subsequently acquired. The depreciation method used in claiming depreciation on a particular asset for the first time will be presumed to be the depreciation method selected for that asset. A provider need not use the same method for all depreciable property. Also, a provider may elect to use a different depreciation method for similar property acquired later. However, if a provider wishes to change methods, a formal request and approval by the fiscal intermediary will be necessary as explained under the "Change of Depreciation Method" section.

116.1 Straight-line Method.—Under this method the annual allowance is determined by dividing the cost of the asset (less any estimated salvage value) by the years of useful life. This method produces a uniform allowance each year. The following examples illustrate how depreciation is computed:

NEW ASSET

Facts: Acquisition cost	\$17,000
Estimated salvage value	2,000
Estimated useful life	5 years

Annual depreciation is computed as follows:

Acquisition cost	\$17,000
Less: Estimated salvage value	2,000
Basis for depreciation	<u>\$15,000</u>
Basis for depreciation	Useful Life
$\frac{\$15,000}{5 \text{ years}} = \$3,000 \text{ each year}$	

The annual allowance can also be computed by using a percentage applied to the basis for depreciation. For example, in the above illustration, a five year life produces a 20% rate (100%/5 years). This 20% rate when applied to the \$15,000 basis for depreciation results in an annual \$3,000 depreciation allowance for each of the five years.

USED ASSET

Facts: Historical cost	\$46,000
Salvage value	1,000
Estimated useful life	15 years
Years asset used by provider before entrance into program	10 years
Straight-line method of depreciation to be used for medicare purposes.	

Annual depreciation is computed as follows:

- Determine the number of remaining years of useful life (15 years minus 10 years = 5 years of remaining useful life).
- Determine the basis for depreciation as follows:

Cost	\$46,000
Deduct: Salvage value	1,000
Balance	<u>\$45,000</u>

Deduct: Accumulated depreciation under the straight-line method for 10 years

(10 years x \$45,000) =	\$450,000
15 years	
Basis for depreciation -----	<u>\$15,000</u>

- c. Divide the basis for depreciation by the number of years of remaining life:

Item b =	\$15,000	= \$3,000 annual depreciation
Item a =	5 years	

116.2 Sum-of-the-years' Digit Method.—Under this method, the annual depreciation allowance is computed by multiplying the basis for depreciation (cost less estimated salvage value) by a constantly decreasing fraction. The numerator of the fraction represents the remaining years of useful life of the asset at the beginning of each year and the denominator represents the sum of the years of estimated useful life at the time of acquisition in case of new assets or at time of entrance into the program in the case of used assets. The following example illustrates how depreciation is computed.

NEW ASSET

Facts: Cost -----	\$17,000
Estimated salvage value -----	2,000
Estimated useful life -----	5 years

Depreciation is computed as follows:

- Add each number in the estimated useful life (5 years: $1 + 2 + 3 + 4 + 5 = 15$).
- Use the sum 15 as the denominator of the fraction.
- Each year, for the numerator of the fraction use the remaining years of useful life including the year for which depreciation is taken. This means using each number in a. above in inverse order (5,4,3,2,1) i.e., 5 for the first year, 4 for the second year, 3 for the third year, etc.
- Multiply the basis for depreciation by this fraction ($\frac{c}{b}$)

Cost -----	\$17,000
Salvage -----	2,000
Basis for depreciation -----	<u>\$15,000</u>

Annual Computation

Year	Basis for Depreciation	Ratio	Annual Depreciation Allowance
1st	\$15,000	$\times \frac{5}{15} =$	\$5,000
2nd	15,000	$\times \frac{4}{15} =$	\$4,000
3rd	15,000	$\times \frac{3}{15} =$	\$3,000

USED ASSET

Facts: Cost -----	\$46,000
Salvage value -----	1,000
Estimated useful life -----	15 years
Provider used the asset (prior to entrance into the program) for -----	10 years

Annual depreciation is computed as follows:

- Determine the number of remaining years of useful life (15 years minus 10 years = 5 years of remaining useful life).
- Add each number of the remaining years of useful life (5 years = $1 + 2 + 3 + 4 + 5 = 15$).

- c. Use the sum 15 as the denominator of the fraction.

- d. Each year, for the numerator of the fraction use the remaining years of useful life including the year in which depreciation is taken. This means using each number in (b) above in inverse order (5,4,3,2,1), i.e., 5 for the first year under the program, 4 for the second year under the program, 3 for the third under the program, etc.

- e. Determine the basis for depreciation as follows:

Cost -----	\$46,000
Deduct: Salvage value -----	1,000
Balance -----	<u>\$45,000</u>
Deduct: Accumulated depreciation under straight-line method for 10 years	
($\$45,000 \times \frac{10 \text{ yrs.}}{15 \text{ yrs.}}$) -----	\$30,000
Basis for depreciation -----	<u>\$15,000</u>

- f. Multiply the basis for depreciation (e) by the fraction ($\frac{d}{c}$) to determine annual depreciation.

Annual Computation

Year	Basis	Ratio	Annual Depreciation Allowance
1st	\$15,000	$\times \frac{5}{15} =$	\$5,000
2nd	\$15,000	$\times \frac{4}{15} =$	\$4,000
3rd	\$15,000	$\times \frac{3}{15} =$	\$3,000

116.3 Declining Balance Method.—Under this method the annual allowance is computed by multiplying the undepreciated balance of the asset each year by a uniform rate up to double the straight-line rate. Salvage value is not considered in computing the depreciation allowance. However, under this method, the asset should not be depreciated below the estimated salvage value.

NEW ASSET

Facts: Cost -----	\$17,000
Salvage value -----	2,000
Estimated useful life -----	5 years
Rate to be used -----	Double the straight-line rate: $2 \times 20\% = 40\%$

Annual Depreciation is computed as follows:

Year	Undepreciated Balance	Rate	Annual Depreciation Allowance
1st	\$17,000	$\times 40\% =$	\$6,800
2nd	10,200	$\times 40\% =$	\$4,080
3rd	6,120	$\times 40\% =$	\$2,448

USED ASSETS

Facts: Cost -----	\$46,000
Salvage value -----	1,000
Estimated useful life -----	15 years
Provider used the asset (prior to entrance into the program) -----	10 years
Double the straight-line rate to be used under the program.	

Annual depreciation is computed as follows:

- Determine the number of remaining years of useful life. (15 years minus 10 years = 5 years of remaining useful life).

- b. Determine the straight-line rate for the remaining years of useful life ($\frac{100\%}{5 \text{ yrs.}} = 20\%$).

- c. Double the straight-line rate ($2 \times 20\% = 40\%$).

- d. Determine the basis for depreciation as follows:

Cost	\$46,000
Deduct: Salvage value	1,000
Balance	\$45,000
Deduct: Accumulated depreciation under straight-line method for 10 years	
\$45,000 $\times \frac{10 \text{ years}}{15 \text{ years}}$	\$30,000
Balance	\$15,000
Salvage value	1,000
Basis for depreciation (or unrecovered cost in first year under the program)	\$16,000

- e. Multiply each year's undepreciated balance (or unrecovered cost) by 40% (Note: Do not depreciate the asset below its salvage value).

Year	Undepreciated Balance	Rate	Annual Allowance Depreciation
1st	\$16,000	$\times 40\%$	\$6,400
2nd	\$ 9,600	$\times 40\%$	\$3,840
3rd	\$ 5,760	$\times 40\%$	\$2,304
4th	\$ 3,456	$\times 40\%$	\$1,382
5th	\$ 2,074	$\times 40\%$	\$ 830

116.4 Comparison of Depreciation Methods.

A comparison of annual depreciation under each of the three acceptable methods of computing depreciation is reflected in the following table. (Salvage value at the end of the fifth year is \$2,000):

Straight-line	Sum-of-the-years' Digits	Double Declining Balance
Rate:—20% (5/15, 4/15, 3/15, etc.)	Undepreciated Annual Balance Allowance	Undepreciated Annual Balance Allowance
Year Balance Allowance	Undepreciated Annual Balance Allowance	Undepreciated Annual Balance Allowance
\$17,000	\$17,000	\$17,000
—2,000 (Salvage Value)	—2,000 (Salvage Value)	—0 (No Salvage Value)
1st \$15,000	\$ 3,000	\$ 5,000
2nd 12,000	3,000	4,000
3rd 9,000	3,000	3,000
4th 6,000	3,000	2,000
5th 3,000	3,000	2,000
	\$15,000	\$15,000

* Although depreciation at 40% of the undepreciated balance would amount to \$881, this amount cannot be used because an asset cannot be depreciated below its salvage value, and \$881 would bring the undepreciated balance below salvage value (\$2,000). Instead, however, the amount of depreciation to be taken for the fifth year would be the amount that would bring the undepreciated balance to the salvage value:

Undepreciated balance at beginning of 5th year	\$2,203
Maximum depreciation for 5th year	203
Undepreciated balance at end of 5th year equal to salvage value	\$2,000

118. DETERMINING DEPRECIATION IN YEAR OF ACQUISITION AND DISPOSAL

The amount of depreciation recorded during the year of acquisition and year of disposal varies among providers. The following methods are acceptable for computing first and last year depreciation amounts. Any other method for computing first and last year depreciation must be approved by the intermediary. Whatever method is adopted, it must be applied to all assets subsequently acquired.

A. *Time Lag Alternatives.*—These result in delayed recording of depreciation after the actual date of acquisition. However, they provide the convenience of updating detailed, supportive accounting records at the end of certain extended time intervals.

1. Up to 6 Months Time Lag—Assets acquired during the first 6 months of the reporting year are subject to depreciation beginning with the first day of the seventh month of the reporting year.

Assets acquired during the second 6 months of the reporting year are subject to depreciation beginning with the first day of the subsequent reporting year.

Depreciation on disposal is based on the portion of the year in which the asset is disposed. If the asset is disposed of in the first half of the reporting year, one-half year's depreciation is taken. If the asset is disposed of in the second half of the year a full year's depreciation is taken.

2. Up to One Year Time Lag—Assets acquired during the reporting year become effective for depreciation on the first day of the subsequent reporting year. In the year of disposal a full year's depreciation is taken.

Note: A variation of the above methods by use of a quarterly or monthly basis for determining depreciation in the first year and the year of disposal, would be acceptable.

B. *Half Year Depreciation.*—One half year depreciation is taken in the year of acquisition regardless of acquisition date and one half year depreciation is taken on disposition regardless of disposition date.

C. *Actual Time Depreciation.*—Depreciation for the first reporting period is based on the length of time

from the date of acquisition to the end of the reporting year. Depreciation on disposal is based on the length of time from the beginning of the reporting year in which the asset was disposed to the date of disposal.

120. CHANGE OF DEPRECIATION METHOD

Generally, a provider will adhere to the particular depreciation method or methods selected initially until final depreciation of the asset. After the initial selection, a provider may change only once to any of the other allowable methods, provided advance approval has been obtained from the intermediary. A request for change in the depreciation method must be made no later than the last day of the first month of the accounting year in which the new method is to be employed.

If the new method of depreciation is the straight-line or sum-of-the-years' digits, the basis for depreciation will be the undepreciated balance (unrecovered cost) reduced by the salvage value. If the new method of depreciation is the declining balance, the basis for depreciation will be the undepreciated balance (unrecovered cost).

The new basis for depreciation will be treated as though it were the basis for depreciation of a new asset, and depreciation would be based on the remaining years of useful life. (In this respect see computation of depreciation on "used" assets under the particular method of depreciation.)

122. CHANGING ESTIMATED USEFUL LIFE

A. *Assets Acquired after Provider's Entrance into the Program.*—When the estimate of the useful life of such an asset is changed, the undepreciated balance as of the date of change is depreciated over the new remaining useful life. The following examples illustrate how the new annual depreciation is computed under the *accelerated* methods of depreciation.

EXAMPLE #1—Declining balance method.

An asset costing \$10,000, and having an estimated useful life of 10 years has been depreciated for 6 years at the declining balance rate of 20%. The depreciation accumulated during the 6 years is \$7,378.60, and the undepreciated balance is \$2,621.40.

At the end of the sixth year, it is determined that the remaining useful life is 8 years. Accordingly, future depreciation must be computed as though the estimate of useful life was originally determined to be 14 years. The applicable depreciation rate would be 14% (twice straight-line rate of 7%). This rate would be applied to the undepr-

ciated balance. Thus, for the 7th year the depreciation would be 14% times \$2,621.40—or—\$374.49.

EXAMPLE #2—Sum-of-the-years' digits method.

An asset having an estimated useful life of 10 years is purchased for \$10,500. Salvage value is estimated at \$500. After five years the accumulated depreciation under the sum-of-the-years' digits method amounts to \$7,272.70; the undepreciated balance of the cost is \$3,227.30. At the beginning of the sixth year it is determined that the asset has 9 years more of useful life.

Depreciation for the sixth year should be computed as though the sixth year were the first year of life on an asset estimated to have a useful life of 9 years. Accordingly, the depreciation for the sixth year (or first year under the new estimate) would be computed as follows:

Basis for depreciation:

Unrecovered cost	\$3,227.30
Less: Salvage value	500.00
Basis for depreciation	<u>\$2,727.30</u>
Sum-of-the-years' digits (1+2+3, etc. . . +9) =	45
Depreciation = 9/45 × \$2,727.30 =	<u>\$ 545.46</u>

B. *Assets Acquired before Provider's Entrance into the Program.*—Where a change is made in the estimate of the useful life of an asset that was acquired before the provider's entrance into the program, it will be necessary to correct prior year's depreciation for both the periods before and after entrance into the program. The following example illustrates how the correction is computed.

EXAMPLE

Facts:

Asset acquired 3 years before entrance into program.	
Historical cost of the asset	\$30,500
Estimated remaining useful life at entrance into program	7 years
Estimated salvage value	\$ 500
Straight-line depreciation used under the program.	
At beginning of 5th year under the program it is estimated that the asset has 8 more years of useful life.	

Computation of depreciation for the 5th year under the program

New estimated useful life	15 years
3 years before the program	
4 years under the program	
8 years more useful life	
<u>15 years of useful life</u>	
Historical cost	\$30,500
Depreciation accumulated prior to program	
3 years × (\$30,500-\$500 salvage value)	6,000
15 years	

Adjusted historical cost	\$24,500
Deduct: Salvage value	500
Adjusted basis for depreciation under the program	\$24,000
Annual depreciation under the program	
<u>\$24,000</u>	
12 years of useful life under program ==	\$ 2,000
Depreciation for the fourth year and annually thereafter is	\$ 2,000
Correction of prior years' depreciation	
Original estimated useful life	10 years
Historical cost	\$30,500
Depreciation accumulated prior to program on basis of estimate of 10 years' useful life	
$3 \text{ years} \times \frac{(\$30,500 - \$500)}{10 \text{ years}} =$	9,000
Adjusted historical cost	\$21,500
Deduct: Salvage value	500
Adjusted basis for depreciation under the program	\$21,000
Depreciation that was taken under the program in four years	
$4 \text{ years} \times \frac{\$21,000}{7 \text{ years}} =$	\$12,000
Corrected depreciation for four years under the program based on estimated useful life of 15 years (4 years \times \$2,000 annual depreciation)	8,000
Reduction of prior years' depreciation under the program	\$ 4,000*

* Reduction of \$4,000 must be applied to current year's depreciation.

124. OPTIONAL ALLOWANCE FOR DEPRECIATION BASED ON A PERCENTAGE OF OPERATING COST

For all depreciable assets acquired before January 1, 1966, the provider, at its option, may at the time it enters the program choose an allowance for depreciation based on a percentage of operating costs. This option is available to any provider, regardless of whether or not the provider has historical cost records of these assets. However, a provider that has elected to use actual depreciation cannot at a later date switch to the optional allowance.

The operating costs to be used are the lower of the provider's 1965 operating costs or the provider's current year's allowable costs. The percentage to be applied is 5 percent for all reporting periods beginning in the year 1966-67 (July 1, 1966—June 30, 1967); 4½ percent for all reporting periods beginning in the year 1967-68 (July 1, 1967—June 30, 1968), with such percentage being uniformly reduced by one-half percent each succeeding year.

The allowance based on operating costs is in addition to regular depreciation on assets acquired after 1965. However, when the optional allowance is

selected, the combined amount of such allowance on pre-1966 assets and the straight-line depreciation on assets acquired after 1965, and the estimated depreciation on a straight-line basis on all rented assets used during the current year may not exceed 6 percent of the provider's adjusted allowable cost for the current year. In applying this limitation, if the actual depreciation claimed on post-1965 assets is on an accelerated basis, it must be converted to a straight-line basis only for use in computing this limitation. The actual depreciation claimed on an accelerated basis is properly includable in allowable costs.

124.1 Definitions.—

A. *Operating Costs.*—Operating costs are the total costs, related to patient care, incurred by the provider in operating the institution or facility.

B. *1965 Operating Costs.*—1965 Operating costs are the provider's operating costs incurred in the provider's fiscal year beginning in the period 8/1/64—7/31/65 without adjustment to medicare's principles of reimbursement for provider costs. When the 1965 operating costs are used as a base for determining the optional allowance for depreciation, such costs must be adjusted to exclude the estimated depreciation on rented depreciable type assets or the rental charge for such assets whichever is lower; and in addition, the 1965 operating cost must not include any actual depreciation, an amount in lieu of specific recognition of other costs, "a plus factor," or return on equity capital.

C. *Allowable Costs.*—Allowable costs are those costs includable in cost reimbursement under the medicare principles of reimbursement for provider costs. When the current year's allowable costs are used as a base for the optional allowance for depreciation, they should be adjusted to exclude (1) any actual depreciation, (2) the lesser of rental charges or estimated depreciation on rented depreciable type assets, (3) allowance in lieu of specific recognition of other costs, and (4) return on equity capital. The exclusion of these four items is only for the purpose of computing the optional allowance for depreciation. For other purposes, rental charges and excluded items (1), (3), and (4) are recognized in determining allowable costs and for computing the costs of services rendered to the program beneficiaries during the reporting period.

Where a provider files a short-period report, the allowable costs must be converted to a full year's basis (see example 3) only for the purpose of computing the optional allowance.

124.2 Applicable Percentages.—The percentage to be applied in each reporting year is shown in the following schedule:

Reporting year beginning		Percentage Allowance
After	but Before	
-----	7/1/67	5
6/30/67	7/1/68	4½
6/30/68	7/1/69	4
6/30/69	7/1/70	3½
6/30/70	7/1/71	3
6/30/71	7/1/72	2½
6/30/72	7/1/73	2
6/30/73	7/1/74	1½
6/30/74	7/1/75	1
6/30/75	7/1/76	½
6/30/76	7/1/77	0

124.3 Computation of Optional Allowance for Depreciation.—The following illustrates the determination of the optional allowance for depreciation based on operating costs:

EXAMPLE 1

Facts:

The provider keeps its records on a calendar year basis. The current year's actual allowable cost and the actual operating costs for 1965 do not include any actual depreciation or rentals on depreciable type assets. The current year's allowable cost has been adjusted to remove any allowance in lieu of specific recognition of other costs and return on equity capital.

Computation

First Reporting Period (1/1/66–12/31/66)

Adjusted current year's allowable cost -----	\$1,100,000
Operating cost for 1965 ¹ -----	\$1,000,000
Percent for determining the allowance -----	5%
Allowance (5% × \$1,000,000) -----	\$ 50,000

¹ 1965 Operating cost was used in computing the allowance for depreciation because it was lower than 1966 adjusted allowable cost.

Second Reporting Period (1/1/67–12/31/67)

Adjusted current year's allowable cost -----	\$1,200,000
Operating cost for 1965 ¹ -----	\$1,000,000
Percent for determining the allowance ² -----	5%
Allowance (5% × \$1,000,000) -----	\$ 50,000

¹ 1965 operating cost was used in computing the allowance for depreciation because it was lower than 1967 adjusted allowable cost.

² Since the reporting period began during the year 1966–67 (July 1, 1966–June 30, 1967) 5 percent is the percentage to be used.

Third Reporting Period (1/1/68–12/31/68)

Operating cost for 1965 -----	\$1,000,000
Current year's adjusted allowable cost ¹ -----	\$ 900,000
Percent for determining the allowance ² -----	4½%
Allowance (4½% × \$900,000) -----	\$ 40,500

¹ The current year's adjusted allowable cost was used in computing the allowance for depreciation because it was lower than 1965 operating cost.

² Since the reporting period began during the year 1967–68 (July 1, 1967–June 30, 1968) 4½ percent is the percentage to be used.

EXAMPLE 2

Facts:

The provider keeps its records on a calendar year basis. The current year actual allowable cost and the actual operating

cost for 1965 did not include any actual depreciation, nor return on equity capital. However, both 1965 and the current year's costs have been adjusted to exclude depreciation (\$3,000 for 1965, \$2,000 for the current year) on rented depreciable type assets. The current year's allowable cost has also been adjusted to remove the allowance in lieu of specific recognition of other costs and return on equity capital.

Computation

First Reporting Period (1/1/66–12/31/66)

Adjusted current year's allowable cost -----	\$1,100,000
Adjusted operating cost for 1965 ¹ -----	\$1,000,000
Percent for determining the allowance -----	5%
Allowance (5% × \$1,000,000) -----	\$ 50,000
Less: Estimated depreciation for depreciable type assets on which rental of \$5,000 is paid in 1966 -----	\$ 3,000
Adjusted allowance -----	\$ 47,000

¹ 1965 adjusted operating cost was used in computing the allowance for depreciation because it was lower than 1966 adjusted allowable cost.

EXAMPLE 3

Facts:

The provider keeps its records on a calendar year basis. The provider's first report will be a short period one of six months, July 1, 1966–December 31, 1966. The current year's actual allowable cost and the actual operating costs for 1965 do not include any actual depreciation or rentals on depreciable type assets. The current year's allowable cost has been adjusted to remove the allowance in lieu of specific recognition of other costs.

Computation

First Reporting Period (7/1/66–12/31/66)

Adjusted current year's allowable cost (6 months) -----	\$ 575,000
Adjusted current year's allowable cost converted to a 12-month period (2 × \$575,000) -----	\$1,150,000
Operating cost for 1965 ¹ -----	\$1,000,000
Percent for determining allowance -----	5%
Allowance (5% × \$1,000,000) -----	\$ 50,000

¹ 1965 operating cost was used in computing the allowance for depreciation because it was lower than the adjusted allowable costs covering a 12-month period.

Second Reporting Period (1/1/67–12/31/67)

Adjusted current year's allowable cost -----	\$1,200,000
Adjusted operating cost for 1965 ¹ -----	\$1,000,000
Percent for determining the allowance -----	5%
Allowance (5% × \$1,000,000) -----	\$ 50,000
Less: Estimated depreciation for depreciable type assets on which a rental of \$5,000 is paid in 1967 -----	3,000
Adjusted allowance -----	\$ 47,000

¹ 1965 adjusted operating cost was used in computing the allowance for depreciation because it was lower than the 1967 adjusted allowable costs.

124.4 Limitation.—The optional allowance only—not the actual depreciation—is subject to a limitation based on the provider's total allowable operating cost for the current year. To determine this limitation, compute the sum of (a) the actual depreciation

claimed for post-1965 assets computed on a straight-line basis, (b) "the optional allowance based on a percentage of operating costs," and (c) estimated depreciation on depreciable type rented assets used in the current year. If this sum exceeds 6 percent of the provider's current year's adjusted allowable cost (allowable cost reduced by any depreciation claimed, the estimated depreciation on rented depreciable type assets, allowance in lieu of specific recognition of other costs, and return on equity capital), the optional allowance for depreciation must be reduced by the amount of the excess. In applying this limitation if the actual depreciation is on an accelerated basis, it must be converted to a straight-line basis *only* for use in calculating this limitation.

Where the provider files a short-period report, the period's allowable costs, after adjustment to exclude the 4 items mentioned above, must be converted to a full year's basis (see Example 3). Thus if the short-period report is for 8 months, the adjusted allowable costs should be increased by 50%; if the short period is for 9 months, the adjusted allowable cost should be increased by 33⅓%, etc. In addition, the actual depreciation computed on a straight-line basis as well as the estimated depreciation on rented depreciable type assets must be converted to a 12-month or full year's basis.

The following illustration demonstrates how the limitation is determined:

EXAMPLE 4

Facts:

The provider keeps its records on a calendar year basis. For its first report, the provider will use a 6 month's period. The current year's actual allowable cost and the actual operating cost for 1965 have been adjusted to exclude actual depreciation, the estimated depreciation on rented depreciable type assets, allowance in lieu of specific recognition of other costs, and return on equity capital.

Adjusted operating cost for 1965	\$1,000,000
Adjusted allowable operating cost for the last 6 months of 1966	\$ 550,000
In 1966, assets were acquired which produced for 1966 a straight-line depreciation of	\$ 18,000
Estimated depreciation for the year on rented assets used in 1966	\$ 4,000
Estimated annual depreciation on assets rented for which an annual rental of \$5,000 is paid	\$ 3,000

Computation of the Optional Allowance

First Reporting Period (7/1/66-12/31/66)

Adjusted allowable costs for the last 6 months of 1966 converted to a 12 month basis (2 × \$550,000)	\$1,100,000
Gross optional allowance: 5% of adjusted	

1965 operating cost (\$1,000,000) ¹	\$ 50,000
Less: Estimated depreciation on assets rented	3,000
Gross allowance	\$ 47,000
Add: Estimated depreciation for the year on rented assets used in 1966	4,000
Straight-line depreciation on post-1965 assets for 12 months	18,000
Total	\$ 69,000
6% of adjusted 1966 allowable operating cost (6% × \$1,100,000)	66,000
Deduction in allowance	\$ 3,000
Gross Allowance	\$ 47,000
Less: Reduction for excess of 6% limitation	3,000
Net optional allowance for the year	\$ 44,000
Net optional allowance converted to a 6 month period (\$44,000 ÷ 2)	\$ 22,000

¹ The adjusted 1965 operating cost is used because it is lower than the adjusted allowable cost converted to a 12 months' period.

Second Reporting Period (1/1/67-12/31/67)

Facts:

Adjusted allowable cost for 1967	\$1,150,000
Adjusted operating cost for 1965	1,000,000
Percent for determining the allowance	5%
Straight-line depreciation on assets acquired after 1965	\$ 20,000
Estimated depreciation on \$7,000 rental of depreciable type assets used in 1967	4,000
Estimated depreciation on depreciable assets rented on which annual rental of \$5,000 is paid	3,000

Computation:

Gross Optional Allowance	
5% times adjusted 1965 operating cost (5% × \$1,000,000)	\$ 50,000
Less: Estimated depreciation on depreciable assets rented	3,000
Adjusted allowance	\$ 47,000
Add: Straight-line depreciation on post-1965 assets	20,000
Estimated depreciation on depreciable rented assets used in 1967	4,000
Total	\$ 71,000
Less: 6% of adjusted 1967 allowable operating cost	\$ 69,000
Deduction to adjusted allowance	\$ 2,000
Net allowance to be included in allowable cost:	
Adjusted allowance	\$ 47,000
Less: Deduction to adjusted allowance	2,000
Net allowance	\$ 45,000

126. CHANGE FROM OPTIONAL ALLOWANCE TO ACTUAL DEPRECIATION

A provider that elects the optional allowance for depreciation may at any time before 1976 change to actual depreciation on its pre-1966 assets. When a provider switches to actual depreciation it can no longer elect the optional allowance.

When a provider changes to actual depreciation, the

depreciation accumulated to the date of change will be determined in the same manner as accumulated depreciation is determined for used assets when a provider enters the program. Upon disposition of the asset, the determination of gain or loss will be made on the basis of historical cost depreciation for the actual useful life of the asset.

128. ESTIMATED DEPRECIATION PENDING APPRAISAL

For those providers not wishing to use the optional method of depreciation and who have signed contracts to have appraisals made to establish the cost of pre-1966 assets, a reasonable estimate of the actual depreciation may be made, pending completion of the appraisal. Such an appraisal must be completed within two years of the contract date. Until the appraisal is completed an estimated depreciation may be taken for the current cost report, with a retroactive adjustment to the estimated depreciation to be made when the appraisal is completed.

128.1 Limitation.—The estimated depreciation must not exceed 5 percent of 1965 operating costs or the current year's allowable costs, as adjusted for computing the optional allowance for depreciation, whichever is lower. The total allowable estimated depreciation is also subject to an adjustment based on the provider's adjusted allowable cost for the current year. To determine this limitation, compute the sum of (a) the actual depreciation claimed for post-1965 assets determined on a straight-line basis, (b) estimated depreciation on rented depreciable type assets used in the current year, and (c) the estimated depreciation on pre-1966 assets. If this sum exceeds 6 percent of the provider's adjusted current year's allowable cost (allowable cost exclusive of any depreciation claimed, estimated depreciation on rented depreciable type assets, allowance in lieu of specific recognition of other costs and return on owner's equity capital), the reasonable estimated depreciation must be reduced by the amount of the excess.

When the appraisal has been completed, actual depreciation must be computed for the year(s) in which estimated depreciation was taken and compared with the amount of depreciation claimed on the cost report(s). The provider may either submit amended cost report(s) for the year(s) in question or it may adjust the current year's depreciation to reflect the difference between the estimated depreciation and depreciation based on the appraisal of the asset's historical cost. Any current year adjustment

must reflect the medicare percentages of participation for the year(s) in question applied to the difference between the estimated depreciation and depreciation based on the appraisal.

130. DISPOSAL OF ASSETS

Depreciable assets may be disposed of through sale, trade-in, scrapping, exchange, theft, wrecking, fire or other casualty. In such cases, depreciation can no longer be taken on the asset, and gain or loss on the disposition must be computed.

Where an asset has been retired from active service, but is being held for stand-by or emergency services, depreciation may continue to be taken on such assets. However, where the asset has been permanently retired or there is little or no likelihood that it can be effectively used in the future, no further depreciation can be taken on the asset. In such case, gain or loss on the retirement must be computed.

132. GAINS AND LOSSES ON DISPOSAL OF DEPRECIABLE ASSETS

Gains and losses on the disposition of depreciable assets are includable in computing allowable costs. However, gain on the disposal of an asset must not exceed the depreciation accumulated for that asset under the program.

If the gains or losses on the disposal of depreciable assets in a reporting period are greater than ten percent (10%) of the total allowable depreciation for the period, the amount of the excess gain or loss over the ten percent (10%) must be carried forward over the five succeeding years. The identity of the gain or loss carry-forward for each individual year must be maintained in the records. The carry-forward must be considered first in determining the ten percent limitation for the current year.

132.1 Computation of Gain or Loss on Assets Acquired Before the Provider's Entrance into the Program.—When an asset that was acquired before entrance into the program is disposed of, a correction of prior years' depreciation based on actual useful life must be made before determining any gain or loss. The actual useful life will cover the period from date of acquisition to date of disposal. The depreciation accumulated before and after entrance into the program must be corrected in the same manner as when making a new estimate of the asset's useful life. (See § 122) The gain or loss is the difference between the amount received for the disposed asset and the corrected undepreciated cost at

the time of sale. However, where an asset is traded-in for another asset there will be neither a gain nor loss on the disposition. (See § 104.11 for determining the cost of new asset when a trade-in is involved.)

The following example illustrates how to compute gain or loss on disposal of an asset that was acquired before entrance into the program:

EXAMPLE

Facts:

Asset acquired 10 years before entrance into the program	10 years
Estimated remaining useful life at entrance into program	20 years
Total useful life	30 years
Estimated Salvage Value	\$ 10,000
Historical cost	\$310,000
Salvage Value	10,000
Sum-of-the-years' digits method of depreciation used under the program	\$300,000
Accumulated depreciation before entrance into program (using straight-line depreciation)	100,000
Undepreciated balance subject to depreciation under the program	\$200,000
Asset sold at the end of the 15th year under the program for	\$ 1,000
Depreciation accumulated under program for 15 years	\$185,714
Computation of Gain or Loss	
Historical cost	\$310,000
Corrected accumulated depreciation upon entering program—	
$10 \text{ years} \times \frac{\$300,000}{25 \text{ years}} =$	120,000
Undepreciated balance subject to depreciation under the program	\$190,000
Less: Estimated salvage value	10,000
Basis for depreciation—also, total depreciation allowable under the program	\$180,000

Historical cost	\$310,000
Accumulated depreciation before and after entrance into program (\$120,000 + \$180,000)	300,000
Unrecovered cost	\$ 10,000
Sales price	1,000
Loss	\$ 9,000
Share of loss under program =	
$\frac{15 \text{ yrs (medicare)}}{25 \text{ yrs (useful life)}} \times \$9,000 =$	\$ 5,400
Correction of accumulated depreciation under the program:	
Depreciation taken	\$185,714
Correct depreciation	180,000
Excess depreciation taken	5,714
Reduction of depreciation for the year	\$ 314

13.2.2 Computation of Gain or Loss on Assets Acquired Under the Program.—Gain or loss on the disposal of assets acquired under the program is the difference between the sale price of the asset and the asset's unrecovered cost.

EXAMPLE

Facts:

Asset acquired for	\$310,000
Estimated life	30 years
Estimated salvage value	\$ 10,000
Asset sold at end of 25th year for	\$ 25,000
Sum-of-the-years' digits used in depreciating asset—	
Depreciation for 25 years	\$290,325
Computation of Gain or Loss	
Sales price of asset	\$ 25,000
Less: Unrecovered cost:	
Historical cost	\$310,000
Deduct: Accumulated Depreciation for 25 years	290,325
Gain on disposal	\$ 5,325





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